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# TAXING LEVERAGED INVESTMENTS OF CHARITABLE ORGANIZATIONS: WHAT IS THE RATIONALE?

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CHARITABLE organizations<sup>1</sup> generally are exempt from tax on passive investment income.<sup>2</sup> If the property producing such in-

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1. The term "charitable organizations" is used in this Article to refer to all organizations that are described in section 501(c)(3) of the Internal Revenue Code of 1986. These organizations are exempt from tax under I.R.C. § 501(a) (1986). Section 501(c)(3) provides for the exemption of:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3) (1986).

2. The term "passive investment income" is not found in the Internal Revenue Code. As used in this Article, it refers to the following types of income which are excluded from the definition of unrelated business taxable income: "dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, royalties (as described in I.R.C. § 512(b)(2)), rents (as described in I.R.C. § 512(b)(3)), "gains or losses from the sale, exchange, or other disposition of property other than . . . stock in trade or

come is acquired with borrowed funds, however, the debt-financed property rules of section 514<sup>3</sup> treat all or part of the income as unrelated business taxable income with the result that it is subject to tax.<sup>4</sup>

The tax treatment of income from the debt-financed investments of tax-exempt entities has been the subject of recurring debate for forty years,<sup>5</sup> and remains unsettled today. Congressional action has ranged from narrow anti-abuse provisions,<sup>6</sup> to broad sweeping measures,<sup>7</sup> to narrow piecemeal exceptions.<sup>8</sup> Numerous arguments have been presented for and against the taxation of debt-financed property.<sup>9</sup> Nonetheless, the debate over the taxation

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other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or . . . property held primarily for sale to customers in the ordinary course of the trade or business . . . [and] all gains on the lapse or termination of [certain] options [as described in I.R.C. § 512(b)(5)]." I.R.C. § 512(b) (1986).

Certain other organizations and pension trusts described in § 401(a) are also exempt from tax on passive investment income. See I.R.C. § 512(a)(3), (b)(1)-(3) & (5) (1986). The scope of this Article is limited to charitable organizations although reference to other exempt organizations and pension trusts are included where appropriate.

3. I.R.C. § 514 (1986). As is frequently the case in tax law, section 514 is a complex statute with many intricate computations and exceptions. In general, section 514 requires exempt organizations to include in their unrelated business taxable income a fraction of the income received from any property with respect to which there is acquisition indebtedness (debt incurred in connection with the acquisition or improvement of the property). The fraction of income included is the average acquisition indebtedness with respect to the property during the taxable year divided by the average adjusted basis of the property during the taxable year. I.R.C. § 514(a) (1986). There are a number of exclusions from the definition of debt-financed property, including the following: (1) property the use of which is substantially related to the exempt purpose of the organization, (2) property used for research activities, the income from which is specifically excluded from tax under section 512, and (3) property used in certain other trades or businesses, the income from which is excluded under section 513, namely, businesses run by volunteers, businesses run for the convenience of members, students, etc., and businesses involving the sale of donated property. I.R.C. § 514(b) (1986). In addition, there is an exception for the debt-financed acquisition of real estate by "qualified organizations," namely, educational institutions and pension trusts, if certain conditions are met. I.R.C. § 514(c)(9) (1986).

4. I.R.C. § 512(b)(4) (1986) (income from debt-financed property shall be characterized as "gross income derived from an unrelated trade or business" and shall be taxed).

5. Congress first dealt with the issue in 1950, when it passed legislation taxing income from certain business leases. See *infra* notes 15-50 and accompanying text.

6. *Id.*

7. In 1969, Congress passed legislation taxing income from debt-financed property if the property was unrelated to the tax-exempt organization's charitable function. See *infra* notes 51-59 and accompanying text.

8. In 1980, Congress excepted certain real estate investments made by qualified pension trusts from the debt-financed property rules. See *infra* notes 60-69 and accompanying text. Congress extended the same exception to schools in 1984. See *infra* notes 70-88 and accompanying text.

9. See *infra* notes 112-60 and accompanying text.

of income from debt-financed property continues. In spite of the numerous amendments to this law, the policy behind it remains unclear. Moreover, these amendments have created a law that distinguishes among charitable organizations in a manner that is arguably unfair.

This Article traces the historical development of the tax treatment of income from debt-financed property,<sup>10</sup> and examines whether the current statute is an effective means of achieving the objectives that have been articulated as the policy rationale for the law.<sup>11</sup>

## I. HISTORICAL DEVELOPMENT OF THE LAW

### A. Destination of Income Test

Prior to 1950, the exemption for a charitable organization from federal income tax applied to all income of the organization, so long as the income was dedicated to charitable purposes.<sup>12</sup> The majority of courts held that the destination of an organization's income, not its source, was the appropriate test for tax exemption.<sup>13</sup> Under this so-called "destination of income" test, an organization engaged exclusively in commercial, non-exempt activities was treated as exempt from tax if all its profits were distributed to an exempt organization.<sup>14</sup>

### B. The Revenue Act of 1950

In 1950, Congress rejected the "destination of income" test and imposed a tax on the unrelated business activities of tax-ex-

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10. See *infra* notes 12-111 and accompanying text.

11. See *infra* notes 112-60 and accompanying text.

12. The federal tax law has expressly provided for tax exemption of charitable, religious, and educational organizations since 1894. In that year, the first federal act imposing a general tax on the income and profits of corporations was enacted. Act of Aug. 27, 1894, ch. 589, § 32, 28 Stat. 509, 556.

13. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *Sand Springs Home v. Commissioner*, 6 B.T.A. 198 (1927); see Note, *Colleges, Charities and the Revenue Act of 1950*, 60 YALE L.J. 851, 854 n.18 (1951).

14. See *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938) (corporation formed to hold property and conduct business granted tax exemption because all profits were funnelled to a separate non-profit organization); *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922 (1950) (held that the corporation was not exempt because it was not operated exclusively for charitable purposes), *rev'd*, 190 F.2d 120, 122 (3d Cir. 1951) ("The instant case . . . fits squarely within the *Roche's Beach* decision as the purpose of the corporation involved is wholly charitable.").

empt organizations.<sup>15</sup> The legislative history indicates that the primary purpose of the tax was to eliminate the "unfair"<sup>16</sup> competitive advantage that tax exemption accorded exempt organizations in business activities unrelated to their exempt purposes.<sup>17</sup> Certain "passive" income was expressly excluded from the definition of unrelated business taxable income. Specifically, the tax was not imposed on dividends, interest, royalties (including overriding royalties), rents (other than certain rents on property acquired with borrowed funds), and gains from sales of leased property.<sup>18</sup> This exclusion was justified on the ground that investments producing

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15. In general, the unrelated business income tax (UBIT) is imposed on the unrelated business taxable income (UBTI) of organizations that are otherwise exempt from tax under section 501(a). I.R.C. § 511(a) (1986). Tax-exempt trusts are taxed at individual tax rates and all other exempt organizations are taxed at corporate rates. I.R.C. § 511(b) (1986).

The term "unrelated trade or business" means any trade or business that is regularly carried on and is not substantially related, aside from the need of the organization for funds, to the performance of the purpose for which the organization was granted exempt status. I.R.C. § 513(a) (1986). Specifically excluded from the term "unrelated trade or business" is any trade or business in which substantially all the work is performed by volunteers; which is carried on by a section 501(c)(3) organization or a state or city college or university primarily for the convenience of its members, students, patients, officers, or employees; or which is selling merchandise received as gifts or donations. I.R.C. § 513(a) (1986).

UBTI is defined as the gross income derived from any unrelated trade or business less deductions directly connected with the carrying on of such trade or business, subject to certain modifications. I.R.C. § 512(a) (1986). The most significant of these modifications is the exclusion of passive income. I.R.C. § 512(b) (1986). See *supra* note 2 and accompanying text.

Congress also enacted in 1950 the "feeder organization" provisions of section 502. That section provides that an organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt on the ground that all of its profits are payable to exempt organizations.

16. The meaning of the term "unfair" and the controversy over whether exempt organizations have any real competitive advantage over for-profit organizations have been the subject of lively debate, particularly in recent years. See, e.g., Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 394 (S. Rose-Ackerman ed. 1986); Note, *supra* note 13, at 876.

17. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 38-40 (1950).

18. Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 948-49 (amending I.R.C. § 422 as it then existed)(currently codified at I.R.C. § 512(b) (1986)). The common practice is to refer to these exceptions collectively as the "passive income exception." This practice, however, is somewhat misleading, because all of these items are excludable without regard to the active or passive nature of the activity that generated the income. But see *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1189-90 (Ct. Cl. 1981)(rental of exempt organization's mailing list was denied passive income treatment as a royalty under I.R.C. § 512(b) because the rental was "the product of extensive business activity"), *aff'd*, 704 F.2d 1570 (Fed. Cir. 1983).

such income "are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income." Furthermore, Congress noted that such investments had "long been recognized as . . . proper . . . for educational and charitable organizations."<sup>19</sup>

The exclusion for passive income, however, did not apply to certain rents on property acquired with borrowed funds.<sup>20</sup> These rents were subjected to tax in an effort to prevent certain sale and lease-back transactions<sup>21</sup> that created unintended benefits. In such transactions, a charitable organization would acquire a property (such as real estate) from a taxable business, often borrowing to finance the entire purchase price.<sup>22</sup> As a condition of the sale, the exempt organization would lease the property back to the seller on a long-term basis.<sup>23</sup> The exempt organization would repay the loan, plus interest, with the "rental" received from the seller-lessee.<sup>24</sup> As a result, the exempt organization, while investing and risking little or none of its own funds, obtained the difference between the "rental" payments and the sale price, and eventually secured title to the property outright.<sup>25</sup> The seller treated the sale price as a capital gain, and continued to operate the business, using the "rental" payments as large deductions against the company's taxable income.

Congress identified three principal problems with sale and lease-back arrangements where borrowed funds were used. First, the exempt organization was "trading on its exemption, since the only contribution it [made] to the sale and lease[-back was] its tax exemption."<sup>26</sup> Second, because exempt organizations could acquire property through lease-backs without investing any of their own funds, exempt organizations could conceivably come to "own the great bulk of the commercial and industrial real estate in the country," resulting in a serious erosion of the corporate and indi-

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19. S. REP. NO. 2375, 81st Cong., 2d Sess. 30-31, *reprinted in* 1950 U.S. CODE CONG. & ADMIN. NEWS 3053, 3083.

20. Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 949 (amending I.R.C. § 422(a)(4) as it then existed)(currently codified at I.R.C. § 512(b)(4) (1986)).

21. S. REP. NO. 2375, 81st Cong., 2d Sess. 31-33, *reprinted in* 1950 U.S. CODE CONG. & ADMIN. NEWS 3053, 3083-85.

22. *Id.* at 31, *reprinted in* 1950 U.S. CODE CONG. & ADMIN. NEWS at 3083.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* at 31, *reprinted in* 1950 U.S. CODE CONG. & ADMIN. NEWS at 3084; H.R. REP. NO. 2319, 81st Cong., 2d Sess. 38 (1950).

vidual income tax base.<sup>27</sup> Third, the exempt organization may have "sold" part of its exemption, either by paying a higher price for the property or by charging lower rents than a taxable business.<sup>28</sup>

In response to these three problems, Congress imposed the unrelated business income tax on rentals from leases of real property (and personal property leased in connection with it) if the term of the lease exceeded five years (taking into account options to renew)<sup>29</sup> and borrowed funds were used to acquire or improve the realty.<sup>30</sup> The tax was imposed on a fraction of the rentals equal to the amount of outstanding indebtedness divided by the adjusted basis of the property at the close of the taxable year.<sup>31</sup> Deductions for taxes and other expenses were allowed on the same pro rata basis.<sup>32</sup> Exceptions were provided for leases entered into for purposes "substantially related" to the basis for the organization's exemption and to leases of premises "primarily designed for occupancy, and occupied, by the organization."<sup>33</sup>

Notwithstanding the changes made by the Revenue Act of 1950, tax-exempt organizations continued to enter sale and lease-back transactions. Typically, the arrangements were structured as three-party transactions.<sup>34</sup> Shareholders of a taxable corporation (usually closely-held) would sell their stock to a charitable organization. The charity would pay for the stock with little or no down payment and a nonrecourse promissory note. The charity would then dissolve the corporation and lease its assets for a five-year

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27. S. REP. NO. 2375, 81st Cong., 2d Sess. 31, *reprinted in* 1950 U.S. CODE CONG. & ADMIN. NEWS 3053, 3084.

28. *Id.* See also Note, *Taxation of Sale and Lease-Back Transactions*, 60 YALE L.J. 879, 880 (1951)(analyzing non-tax consequences of sale and lease-back transactions); *id.* at 888 (unfair competition exists even if the property is not debt financed). Cf. Hall, *The Clay Brown Case and Related Problems*, in U. SO. CAL. 18TH TAX INST. 337 (1966)(questioning whether exempt organizations really were paying more than fair market value). Even if the Hall article is correct in arguing that exempt organizations paid no more than fair market value, the situation remains troublesome. As a matter of theory, exempt organizations would have the capability of delivering a price above fair market value, an option unavailable to for-profit organizations.

29. Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 950 (amending I.R.C. § 423(a) as it then existed).

30. *Id.* § 301(a), 64 Stat. at 951-52 (amending I.R.C. § 423(b) as it then existed).

31. *Id.* § 301(a), 64 Stat. at 952 (amending I.R.C. § 423(d)(1) as it then existed).

32. *Id.* (amending I.R.C. § 423(d)(2) as it then existed).

33. *Id.* § 301(a), 64 Stat. at 950 (amending I.R.C. § 423(a) as it then existed).

34. See *Commissioner v. Brown*, 380 U.S. 563, 566 (1965)(the leading case involving a three-party transaction); Beller, *Exempt Organizations: Taxation of Debt-Financed Income*, 24 TAX LAW. 489, 490-92 (1971).

term to a newly-formed corporation, which was usually owned by associates of the former shareholders. The new corporation would pay a large percentage of its profits as "rent" to the tax-exempt entity, which would then turn over most of those payments to the former shareholders as installment payments on the promissory note.<sup>35</sup>

The 1950 legislation was ineffective against these transactions. The selling shareholders were able to treat payments on the promissory note as capital gain, the new corporation was able to deduct the large "rent" payments, and the tax-exempt entity received a portion of the new company's profits tax-free.<sup>36</sup> The parties avoided the tax imposed on rental income by the 1950 legislation by merely negotiating leases with a term of five years or less.<sup>37</sup> In addition, payments made by the new corporations for the lease of personal property in connection with real property were treated as excludable "rent" when received by the exempt organization, even if the real estate in question comprised only a small fraction of the assets leased.<sup>38</sup>

The government failed in its efforts to attack these transactions through administrative pronouncements and litigation. The Internal Revenue Service issued an initial ruling which addressed the effect of these transactions on exempt organizations.<sup>39</sup> The ruling stated that a foundation engaging in a three-way transaction such as the one described above would not be considered to be "engaged exclusively in activities coming within the contemplation of section 101(6) of the Code" (current section 501(c)(3)).<sup>40</sup> In addition, the IRS cautioned that such income would not fall within the exception to the unrelated business taxable income rules for rent.<sup>41</sup> Finally, the ruling suggested that tax-exempt organizations which entered these three-way transactions would expose themselves to a charge of unreasonable accumulation of income under section 3814 (current section 4943).<sup>42</sup>

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35. Beller, *supra* note 34, at 491.

36. *Id.* at 489, 491.

37. See Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, 950.

38. See *University Hill Found. v. Commissioner*, 51 T.C. 548, 570-71 (1969) (foundation not required to pay income and excess profit taxes), *rev'd*, 446 F.2d 701 (9th Cir. 1971) (foundation must pay tax on rental received from personal property leased along with the real property), *cert. denied*, 405 U.S. 965 (1972).

39. Rev. Rul. 54-420, 1954-2 C.B. 128.

40. *Id.* at 130.

41. *Id.*

42. *Id.*



In the courts, the IRS unsuccessfully attacked the capital gain treatment claimed by the original corporation on the sale of the property<sup>43</sup> and the rental deductions claimed by the new corporation.<sup>44</sup> The Supreme Court ultimately decided the capital gain issue in *Clay Brown*.<sup>45</sup> In that case, the stock of a small lumber company in California was sold to a tax-exempt foundation for a small down payment and a promissory note.<sup>46</sup> The company was liquidated and the assets leased for a five-year term to a new company, which paid eighty percent of its profits to the foundation as "rent."<sup>47</sup> The foundation then paid ninety percent of the "rent" to the former shareholders under the terms of the promissory note.<sup>48</sup> When the former shareholders characterized the payments as capital gain, the Internal Revenue Service objected.<sup>49</sup> Justice White, writing for a majority of the Court, sided with the shareholders. He concluded that the foundation's lack of business risk in the transaction had no bearing on the issue of whether it legally constituted a "sale" for purposes of capital gain treatment.<sup>50</sup>

### C. Tax Reform Act of 1969

Following the *Clay Brown* case and a similar decision by the Tax Court in *University Hill Foundation v. Commissioner*,<sup>51</sup> further legislation was introduced to resolve the issue.<sup>52</sup> Testifying in support of this legislation before the House Committee on Ways and Means, the Treasury Department stated that three problems were created by charitable organizations borrowing for investment purposes. Two of these problems had been cited by Congress when it enacted the business lease provisions in 1950: the erosion of the

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43. *Estate of Hawley*, 20 T.C.M. (CCH) 210 (1961)(capital gains treatment allowed); *Union Bank v. United States*, 285 F.2d 126 (Ct. Cl. 1961)(profits received as a result of sale granted capital gains treatment).

44. *E.g.*, *Brekke v. Commissioner*, 25 T.C.M. (CCH) 1063 (1966)(amounts paid were deductible as rent).

45. *Commissioner v. Brown*, 380 U.S. 563 (1965).

46. *Id.* at 567.

47. *Id.*

48. *Id.*

49. *Id.* at 568.

50. *Id.* at 570.

51. 51 T.C. 548 (1969), *rev'd*, 446 F.2d 701 (9th Cir. 1971), *cert. denied*, 405 U.S. 965 (1972).

52. H.R. 15,942, 89th Cong., 2d Sess., 112 CONG. REC. 14,356 (1966); H.R. 15,943, 89th Cong., 2d Sess., 112 CONG. REC. 14,356 (1966)(both bills would have imposed a tax on income received by a tax-exempt organization from property, if the property was unrelated to the charity's exempt function and it was acquired with borrowed money).

tax base that would result if exempt organizations could acquire property without expending their own funds, and the selling by charitable organizations of part of their exemption through the payment of prices above fair market value.<sup>53</sup> The third problem cited by the Treasury Department was the ability of charitable organizations to expand from within without regard to their level of public support.<sup>54</sup> Elaborating on this point, the Treasury Department testified as follows:

By borrowing, the organization can extend the function of its exemption beyond the protection of income stemming from charitable contributions or membership fees; it can use the exemption to develop funds even where there are no contributions or membership fees. . . . The organization which makes such use of its exemption can sever itself from reliance upon contributors or members and eliminate the healthful scrutiny of its purposes and activities which that reliance implies.

By this extension of its exemption privilege to borrowed assets and this separation from dependence upon contributors or members, the organization begins a multiplication of its holdings which bears no relation to the community's evaluation of its exempt activities; it embarks upon an extension of its economic holdings which is limited only by the financial acumen and commercial skills of its managers.<sup>55</sup>

In 1969, Congress passed legislation which taxed income from all debt-financed property (including tangible personal property and business assets) if the property was unrelated to the organization's exempt function. As with the 1950 legislation, the tax on the income from such property was dependent upon the relationship between the amount of indebtedness and the adjusted basis of the property financed.<sup>56</sup> The exception for short-term leases was eliminated.<sup>57</sup> In the committee reports, Congress cited the *Clay Brown* transaction as the reason for the legislation.<sup>58</sup> The

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53. See *supra* notes 27-28 and accompanying text.

54. *Unrelated Debt-Financed Income of Tax-Exempt Organizations: Hearing on H.R. 15,942 and H.R. 15,943 Before the House Committee on Ways and Means*, 89th Cong., 2d Sess. 21-22 (1966)[hereinafter *Unrelated Debt-Financed Income*](statement of Stanley S. Surrey, Assistant Secretary of the Treasury).

55. *Id.*

56. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(d), 83 Stat. 487, 543-48 (current version at I.R.C. § 514 (1986)).

57. *Id.*

58. S. REP. NO. 552, 91st Cong., 1st Sess. 62-63, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2091-92; H.R. REP. NO. 413, 91st Cong., 1st Sess. 44-46,

committee reports made no reference to the Treasury Department's concern about the ability of charitable organizations to grow through leveraged investments.<sup>59</sup>

#### D. Miscellaneous Revenue Act of 1980

Eleven years later, in 1980, Congress enacted an exception to the debt-financed property rules for certain real estate investments of qualified pension trusts.<sup>60</sup> Proponents of the exception made two arguments. First, they claimed that the debt-financed property rules did not apply to pension plan investments in bank common trust funds<sup>61</sup> and life insurance company segregated asset accounts,<sup>62</sup> and as a consequence, the tax law created a competitive imbalance among financial intermediaries offering investment services to qualified pension plans.<sup>63</sup> Second, they argued that because of inflation, there was a need to facilitate real estate investments by qualified pension trusts.<sup>64</sup>

In testimony before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, the Treasury Department rejected each of the proponents' arguments. The first argument was rejected because the Treasury thought that as a matter of policy the income of common trust funds should retain its character in the hands of its participants.<sup>65</sup> The second was re-

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reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1690-91.

59. But in enacting an exception to the debt-financed property rules for qualified pension plans in 1980, the Senate Finance Committee stated that "the 'Clay Brown' provisions were designed in part to prevent uncontrolled growth of exempt organizations through investments financed with debt . . ." S. REP. NO. 1036, 96th Cong., 2d Sess. 29, reprinted in 1980 U.S. CODE CONG. & ADMIN. NEWS 7316.

60. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 110, 94 Stat. 3521, 3525-26 (codified as amended at I.R.C. § 514 (1986)).

61. *Five Misc. Tax Bills: Hearings on S. 650 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Finance Comm.*, 96th Cong., 2d Sess. 295 (1980)[hereinafter *Five Misc. Tax Bills*](statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury).

62. *Five Misc. Tax Bills*, *supra* note 61, at 295. This position is reflected in I.R.C. § 801 (1986).

63. *Five Misc. Tax Bills*, *supra* note 61, at 295.

64. *Id.* at 295-96.

65. *Id.* at 295. The regulations under I.R.C. § 584 were subsequently amended to provide that the debt-financed character of property held by a common trust fund "passed through" to the fund's beneficiaries. See Treas. Reg. § 1.584-2(c)(4)(vi) (as amended in 1984). In 1984, Congress gave the Treasury regulatory authority to prevent the circumvention of section 514 through segregated asset accounts, but no regulations have yet been promulgated. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 1034(b), 98 Stat. 494, 1040.

jected because debt-financing is not an essential, but only a conventional, method of acquiring real estate.<sup>66</sup>

Notwithstanding its reservations, the Treasury Department did not oppose the exception enacted in 1980. Because of the substantial tax benefits available to taxable investors in real estate, the Treasury Department concluded that exempt investors were not likely to have an advantage over taxable investors if they were exempt from tax on debt-financed real estate investments.<sup>67</sup> Further, the Treasury concluded that an exception limited to pension funds could be justified on the ground that the exemption for investment income was the *raison d'être* of the exemption granted to pension funds; whereas the exemption for investment income was a mere "by-product" of exemptions granted to other organizations. For this reason, Treasury was "less troubled" by allowing pension funds to maximize the benefits of their exemptions than it would have been by allowing other tax-exempt organizations to do the same.<sup>68</sup>

Although the Treasury did not oppose the exception enacted in 1980, it insisted on several safeguards in order to prevent a recurrence of the exploitation of debt-financing that existed prior to 1969. The Treasury Department proposed that the purchase price for an exempt leveraged real estate acquisition be fixed in advance, that the price be subject to adjustment only on the basis of limited post-closing contingencies, that the contract not provide for contingent repayments of acquisition indebtedness, that it prohibit debt-financed acquisitions of property leased back to the vendor, that it impose restrictions on the use of nonrecourse financing when taken back by the vendor of the property, and that there be restrictions on acquisitions of real estate by a qualified plan from certain parties related to the plan, such as an employer. With minimal changes, these restrictions were included in section

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66. *Five Misc. Tax Bills*, *supra* note 61, at 296.

67. *Id.* at 298. In fact, exempt organizations, when subjected to tax under I.R.C. § 514, were at a disadvantage compared to taxable entities. Exempt organizations were limited to straight line depreciation under section 514, while taxable entities could use accelerated depreciation. Thus, exempt entities could be taxed at a higher rate than taxable entities when they acquired debt-financed property.

68. *Id.* This distinction between pension funds and other exempt organizations seems sound if the purpose of section 514 is to prevent organizations from growing from within and thereby make them dependent on donors and members. This distinction does not seem meaningful if the purpose of section 514 is to prevent transactions that are viewed as abusive.

514(c)(9) of the Code in 1980.<sup>69</sup>

### E. The Deficit Reduction Act of 1984

Following enactment of the exception for pension funds, legislation was introduced to extend the exception to schools.<sup>70</sup> Testifying on Senate bill 2498 in 1982, the Treasury Department opposed the extension.<sup>71</sup> It stated that the tax on debt-financed income was useful in preventing the creation of unintended benefits from tax-exempt status (such as the transfer of the benefit of tax exemption to taxable parties through partnerships employing

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69. I.R.C. § 514(c)(9), as enacted in 1980, states:

(9) REAL PROPERTY ACQUIRED BY QUALIFIED TRUST. — For purposes of this section —

(A) IN GENERAL. — Except as provided in subparagraph (B), the term "acquisition indebtedness" does not include indebtedness incurred by a qualified trust in acquiring or improving any real property.

(B) EXCEPTIONS. — The provisions of subparagraph (A) shall not apply in any case in which —

(i) the acquisition price is not a fixed amount determined as of the date of acquisition;

(ii) the amount of any indebtedness or any other amount payable with respect to such indebtedness, or the time for making any payment of any such amount, is dependent, in whole or in part, upon any revenue, income, or profits derived from such real property;

(iii) the real property is at any time after the acquisition leased by the qualified trust to the person selling such property to such trust or to any person who bears a relationship described in section 267(b) to such person;

(iv) the real property is acquired from, or is at any time after the acquisition leased by the qualified trust to, any person who —

(I) bears a relationship which is described in section 4975(e)(2)(C), (E), or (G) to any plan with respect to which such trust was formed, or

(II) bears a relationship which is described in section 4975(e)(2)(F) or (H) to any person described in subclause (I); or

(v) any person described in clause (iii) or (iv) provides the qualified trust with nonrecourse financing in connection with such transaction and such debt —

(I) is subordinate to any other indebtedness on such property, or

(II) bears interest at a rate which is significantly less than the rate available from any person not described in clause (iii) or (iv) at the time such indebtedness is incurred.

(C) QUALIFIED TRUST. — For purposes of this paragraph, the term "qualified trust" means any trust which constitutes a qualified trust under section 401.

Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 110, 94 Stat. 3521, 3525-26.

70. S. 2498, 97th Cong., 2d Sess. (1982).

71. 1981-82 *Miscellaneous Tax Bills, XVI: Hearing on S. 2498 Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm.*, 97th Cong., 2d Sess. 53 (1982) (statement of William McKee, Tax Legislative Counsel, Department of the Treasury).

special allocations).<sup>72</sup> It defended the exception for pension funds on the grounds that the exemptions for pensions and schools have different purposes, and that the exemption for pensions results in tax deferral while the exemption for schools often results in a permanent exemption.<sup>73</sup> On the other hand, the Treasury found no basis for differentiating between schools and other organizations exempt under section 501(c)(3) which would continue to be fully subject to the tax on debt-financed property, and opposed "piecemeal" repeal of the provision.<sup>74</sup>

A year later, the Treasury Department testified in opposition to a similar bill.<sup>75</sup> It emphasized the importance of section 514 as an anti-abuse provision,<sup>76</sup> and objected to the bill because it would have permitted a buyer to use nonrecourse financing provided by a seller of property so long as the financing was not subordinate to other debt on the property and the rate of interest was comparable to the market rate. The Treasury Department believed that the bill would enable sellers to convert ordinary income to capital gain. The Treasury was also concerned that the exempt organization would be able to pay an inflated price for the property based on the exempt organization's ability to receive rental income tax-free.<sup>77</sup> It stated further that the possibilities for transferring tax benefits from tax-exempt to taxable partners through partnership allocations were so varied that it was doubtful that rules could be drafted to prevent allocations of this sort.<sup>78</sup> Finally, it observed that the bill would give tax-exempt educational institutions an incentive to solicit gifts of real estate tax shelters which had passed the "cross-over" point at which the taxable income exceeded the cash flow produced, thus providing further tax advantages to the taxable investors.<sup>79</sup> The Treasury opposed the exception for pen-

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72. *Id.* at 54.

73. *Id.* at 55. The latter difference is questionable. If a school uses its investment income to acquire goods or services from taxable persons, the income will become subject to tax in the hands of such persons. Moreover, taxation of pension income may be deferred for forty years.

74. *Id.*

75. S. 1183, 98th Cong., 1st Sess. (1983). For the text of Senate bill 1183 see 5 1983-84 *Misc. Tax Bills: on S. 927, S. 1183 and H.R. 2163: Hearings Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm.*, 98th Cong., 1st Sess. 31-34 (1983) (statement of Robert G. Woodward, Acting Tax Legislative Counsel, Department of the Treasury) [hereinafter 1983-84 *Hearings*].

76. 1983-84 *Hearings*, *supra* note 75, at 86-87.

77. *Id.* at 88.

78. *Id.* at 89.

79. This concern does not appear to have been well founded. In most cases the tax

sions and reiterated the concern that if the exception were extended to schools there would be no principled basis for denying the same exception to other section 501(c)(3) organizations, and perhaps to other tax-exempt organizations as well.<sup>80</sup> Further, it warned that expansion of the exception for investments in real estate might lead to exceptions for investments in other types of property.<sup>81</sup>

Congress was unpersuaded by Treasury's strenuous objection to the piecemeal repeal of section 514, and in 1984 it extended the exception for debt-financed real property to schools.<sup>82</sup> Congress did, however, respond in part to Treasury's concern over potential abuses. It added two further requirements which pension funds and schools must meet in order to qualify for the exception to the debt-financed property rules. First, no part of the financing could be provided by the seller.<sup>83</sup> Second, if the pension fund or school was a partner in a partnership that acquired the debt-financed property, it qualified for the exception only if all of the partners in the partnership were "qualified organizations" (i.e., pension funds or schools) or if each allocation to a partner which was a qualified organization constituted a qualified allocation.<sup>84</sup> An organization was treated as a qualified organization under these requirements only if none of its income was unrelated business taxable income.<sup>85</sup> Generally, an allocation was treated as a qualified allocation if it met the rules governing partnerships under the tax-exempt leasing provisions.<sup>86</sup> Thus, a qualified allocation was an

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cost to the donor of a charitable contribution of such a tax shelter would exceed the tax benefits. See 2 W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 18.02(6) (1977).

80. 1983-84 *Hearings*, *supra* note 75, at 89.

81. *Id.* This prediction proved correct. Later that year, a bill was introduced that provided an exception for investments in limited partnerships which used debt financing to purchase working interests in oil and gas. S. 1549, 98th Cong., 1st Sess. (1983). For the text of Senate bill 1549 see 4 1983-84 *Misc. Tax Bills: Hearings on S. 108, S. 1464, S. 1549, S. 1579 and S. 1600 Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm.*, 98th Cong., 1st Sess. 17-23 (1983).

82. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 114, 98 Stat. 494, 496 (codified at I.R.C. § 514(c)(9)(c)(i) (1986)). A "school" is defined as an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." I.R.C. § 170(b)(1)(A)(ii) (1986).

83. I.R.C. § 514(c)(9)(B)(v) (1986).

84. I.R.C. § 514(c)(9)(B)(vi) (1986).

85. *Id.*

86. I.R.C. § 514(c)(9)(B)(vi)(II) (1986) (referring to I.R.C. § 168(h)(6) (1986)).

allocation under which: (1) the qualified organization was allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property); (2) that share remained the same during the entire period that the organization was a partner; and (3) the allocation had a substantial economic effect, as defined under the rules applicable to partnership allocations generally.<sup>87</sup> In addition, the Treasury was authorized to prescribe regulations concerning the effect of guaranteed payments.<sup>88</sup>

#### F. The Tax Reform Act of 1986

In 1986, Congress added section 501(c)(25) to the Code which granted tax-exempt status to certain real estate title holding companies,<sup>89</sup> and Congress extended to these organizations the exception from the debt-financed property rules for real property.<sup>90</sup> Congress thereby indirectly extended the exception to all organizations that could hold an interest in a section 501(c)(25) organization, including all section 501(c)(3) organizations. Stating that the pre-1986 rules made an untenable distinction between educational organizations and other section 501(c)(3) organizations, the Treasury Department did not object to this extension of

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87. I.R.C. § 704(b)(2) (1986).

88. I.R.C. § 707(c) (1986). The conference agreement stated that, under the Treasury regulations, priority cash distributions to partners that constituted guaranteed payments should not disqualify an otherwise qualified allocation so long as the priority cash distributions were reasonable in amount (e.g., equal to the most appropriate federal rate) and were made to all partners in proportion to their capital in the partnership. The conferees recognized that partnerships might try to avoid the qualified allocation rules by making large guaranteed payments to tax-exempt partners for their use as capital. The conferees expected the Treasury Department to promulgate regulations which would combat this practice. H.R. REP. NO. 861, 98th Cong., 2d Sess., *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697.

89. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1603(a), 100 Stat. 2085, 2768 (codified at I.R.C. § 501(c) (1986)). Section 501(c)(25) provides tax-exempt status to a corporation which acquires real property and remits the entire amount of income from that property (less expenses) to one or more of the following organizations: a qualified pension, profit-sharing, or stock bonus plan that meets the requirements of I.R.C. § 401(a); a governmental plan (within the meaning of I.R.C. § 414(d)); the United States, any state or political subdivision thereof, or any agency or instrumentality of the foregoing; and any organization described in I.R.C. § 501(c)(3). A section 501(c)(25) organization can have no more than 35 shareholders or beneficiaries and only one class of stock. Further, the organization's shareholders or beneficiaries must have certain specified rights over the investment advisor and the right to withdraw from the corporation or trust.

90. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1603(b), 100 Stat. 2085, 2768-69 (codified at I.R.C. § 514 (1986)).



the exception.<sup>91</sup> It also noted that the exception's potential for creating unintended benefits had been reduced by the 1984 amendments.<sup>92</sup>

In addition to broadening the scope of section 514(c)(9), the Tax Reform Act of 1986 also liberalized the rules governing partnership allocations.<sup>93</sup> The new rules permitted a qualified organization that was a partner in a partnership that held debt-financed real property to qualify for the exception, assuming it met the other requirements, if it met the "tax avoidance test." An allocation (other than a qualified allocation to a qualified organization) would fail this test if its principal purpose was the avoidance of income tax. The House Report cited as an example of a permissible allocation a partnership that elected forty-year straight-line depreciation on leased real estate but failed to meet the qualified allocation rule because an increased share of a loss or deduction was allocated to the exempt organization in order to meet the substantial economic effect requirement of section 704(b)(2).<sup>94</sup>

#### G. The Revenue Act of 1987

Section 514(c)(9) was amended again by The Omnibus Budget Reconciliation Act of 1987. This Act replaced the tax avoidance test with an exception to the qualified allocation rule for certain disproportionate allocations.<sup>95</sup> Under the changes made by the 1987 Act, a disproportionate allocation was permitted if throughout the entire period that a qualified organization was a partner in the partnership: (1) no distributive share of overall partnership loss allocable to a partner other than a qualified organization could exceed such partner's smallest distributive share of overall partnership income for any taxable year; (2) no distributive share of overall partnership income allocable to a qualified organization could exceed such partner's smallest distributive share of overall partnership loss for any taxable year; and (3) each

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91. *Miscellaneous Tax Bills, 1986: Hearing on H.R. 3301 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 2d Sess. 187, 190 (1986)(statement of Richard D'Avino, Acting Deputy Tax Legislative Counsel, Department of the Treasury).

92. *Id.*

93. Pub. L. No. 99-514, § 1878(e)(3), 100 Stat. 2085, 2903-04 (codified at I.R.C. § 514 (1986)).

94. H.R. REP. NO. 426, 99th Cong., 1st Sess. 1035 (1985).

95. Revenue Act of 1987, Pub. L. No. 100-203, § 10,214, 101 Stat. 1330, 1330-407 to 1330-408 (1987)(codified at I.R.C. § 514 (1988)).

partnership allocation had substantial economic effect within the meaning of section 704(b).<sup>96</sup> The first two prongs of the test are called the "fractions rule"; the third is referred to as the "substantial economic effect test."

The conference report gave an example of an allocation that was prohibited by the fractions rule.<sup>97</sup> In the example, a partnership that held debt-financed real property was formed by a taxable partner and a qualified organization.<sup>98</sup> Overall partnership income and loss was allocated as follows:

	Qualified Organization	Taxable Partner
Years 1-5		
Income:	60 %	40 %
Loss:	80 %	20 %
Years 6-10		
Income:	40 %	60 %
Loss:	20 %	80 %

The conference report stated that the example failed the fractions rule because of the mismatch between loss and income allocated to the qualified organization in various years. Specifically, the qualified organization's smallest share of loss was twenty percent, and this was exceeded by the allocation to it of sixty percent (in years one through five) and forty percent (in years six through ten) of the overall partnership income.<sup>99</sup> The largest share of income that could be allocated to the tax-exempt partner under the fractions rule was twenty percent. Any portion from zero to twenty percent could be allocated to it. Similarly, the largest share of loss that could be allocated to the taxable partner was forty percent (corresponding to his smallest share of overall partnership income).

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96. *Id.* Under section 704(b), a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement does not have substantial economic effect. I.R.C. § 704(b) (1986). See Treas. Reg. § 1.704-1(b)(2) for the definition of substantial economic effect.

97. H.R. REP. NO. 495, 100th Cong., 1st Sess. 956, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1702.

98. *Id.*

99. *Id.*

## H. The Miscellaneous Revenue Act of 1988

Just one year later, Congress again amended section 514(c)(9). The Technical and Miscellaneous Revenue Act of 1988<sup>100</sup> excluded section 501(c)(25) organizations from the exception for real property contained in section 514(c)(9). Under the changes made by the 1986 Act, the exception is available only to the extent that the shareholders or beneficiaries of the organization would have been treated as qualified organizations prior to the enactment of the 1986 Act.<sup>101</sup> Thus, the 1988 Act repealed the 1986 Act's extension of the section 514(c)(9) exception, and again restricted the exception to pension trusts and schools.

The 1988 Act also amended the disproportionate allocation rule. It deleted the limitation under the fractions rule on the share of loss that could be allocated to a partner that is not a qualified organization, but retained the limitation on the share of gain that can be allocated to a qualified organization.<sup>102</sup> The House report explained that the objectives of the fractions rule — limiting the allocation of income to qualified tax-exempt partners in excess of their smallest share of loss and limiting the allocation of loss to other partners in excess of their smallest share of income — could be accomplished by either part of the rule standing alone.<sup>103</sup> The deletion of the first part of the fractions rule leaves unchanged the limitation on allocations of either overall partnership loss or overall partnership income as between qualified organization partners as a group and other partners as a group.<sup>104</sup> It does, however, remove the limitation on allocations exclusively between partners that are not qualified organizations.<sup>105</sup>

In addition, the 1988 Act provided that the Treasury Department shall prescribe regulations necessary to carry out the purpose of section 514(c)(9).<sup>106</sup> The House report indicated that this regulatory authority was provided because the fractions rule of section 514(c)(9) and the substantial economic effect rule of section 704(b) lead to inconsistent outcomes in some cases.<sup>107</sup> The

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100. Pub. L. No. 100-647, 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342.

101. *Id.* § 1016, 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) at 3573-75.

102. *Id.* § 2004(h), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) at 3603.

103. H.R. REP. NO. 795, 100th Cong., 2d Sess. 405 (1988).

104. *Id.*

105. *Id.*

106. *Id.* at 404.

107. *Id.*

report directed the Treasury to resolve conflicts in a manner that would carry out the congressional purpose of limiting the transfer of tax benefits from tax-exempt partners to taxable partners.<sup>108</sup>

### I. Congressional Hearings

The debt-financed property rules remain in a state of flux. In the 1988 Act, Congress delegated the task of resolving the issue of partnership allocations to the Treasury Department. Further, the Oversight Subcommittee of the House Committee on Ways and Means set forth for public comment a proposal to limit the section 514(c)(9) exception to qualified organizations that made at least a twenty percent equity investment in the property. The Subcommittee also requested public comment on a proposal that debt-financed income received from all pass-through entities should retain its character.<sup>109</sup> These proposals were not, however, contained in subsequent draft recommendations submitted by the chairman to the members of the Subcommittee.<sup>110</sup> The most recent draft recommendations, if adopted, would instead require that the Treasury Department and the Internal Revenue Service study and report to the congressional tax-writing committees on the scope and continued justification of the present exclusions from the unrelated business income tax, including the exclusions for debt-financed income received by certain organizations.<sup>111</sup>

## II. EXAMINATION OF THE POLICY RATIONALES

### A. Overview

Charitable organizations are funded through a variety of sources, including donations, membership dues, government

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108. *Id.*

109. Press Release No. 16, Subcomm. on Oversight, Comm. on Ways and Means, U.S. House of Representatives (March 31, 1988).

The press release set forth "discussion options" which were the result of hearings held by the Subcommittee. The hearings focused on the unrelated business income tax, in particular, and the taxation of the income-producing activities of exempt organizations, in general. They lasted five days, spanning June 22-26, 1988. *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the Comm. on Ways and Means, 100th Cong., 1st Sess. (1987)* [hereinafter *Unrelated Business Income Tax*].

110. These draft recommendations were not officially released to the public by the Subcommittee and were apparently intended only for internal use by the Subcommittee. Nevertheless, copies were obtained by the press. DAILY EXECUTIVE REP. (BNA) (June 24, 1988).

111. *Id.* at L-27.

grants, fees for services, profits from related businesses, tax-free investment income, and taxable income from debt-financed property and unrelated businesses. Historically, when an organization was granted an exemption from federal income tax, all sources of its income were exempt and viewed as an appropriate means of financing the organization's activities, so long as exempting the income source did not have some undesirable collateral effect. Thus, unrelated businesses are taxed because Congress concluded that tax exemption for such businesses resulted in an "unfair" competitive edge for the exempt organizations over their taxable counterparts.<sup>112</sup> In addition to "unfair" competition, Congress was also concerned that these unrelated businesses distracted exempt organizations from their exempt purposes.<sup>113</sup> Passive income, however, was not viewed as a source of unfair competition. Thus, it was not taxed.

When passive income was earned from debt-financed property, however, it was subjected to tax. The historical record is unclear as to whether the taxation of debt-financed property was adopted as an anti-abuse measure or was instead intended to ensure that charitable organizations were reliant upon, and accountable to, the public. The current statute is a hybrid which serves both purposes. On the one hand, with respect to real property held by schools and qualified pension plans, the statute functions as an anti-abuse measure. If the requirements of section 514(c)(9)(B), which are designed to prevent the creation of unintended benefits, are satisfied, then income from debt-financed real property held by such organizations is not taxed because it meets the exception to the general debt-financed property rule. On the other hand, with respect to real property held by organizations other than schools and qualified pension plans (and personal property held by any exempt organization) the statute functions to generally discourage debt-financing, without regard to the potential for abuse. Thus, with respect to these situations, the statute arguably reflects a congressional judgment that debt-financed property is an undesirable asset for exempt organizations.

This part of the Article examines, first, the policy for excluding passive income from tax; second, the need for accountability and whether the debt-financed property rules are an effective means of achieving accountability; third, whether section

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112. See *supra* notes 16-17 and accompanying text.

113. See *infra* note 116 and accompanying text.

514(c)(9) is adequate to prevent exempt organizations from misusing their exempt status; and fourth, whether section 514(c)(9) should be extended to other organizations and other types of property.

### B. The Exclusion for Passive Income

The taxation of debt-financed property operates as a limitation on the otherwise exempt status of passive investment income. Although the passive income exemption is not entirely without its critics,<sup>114</sup> it has been supported on a number of grounds. In 1950, Congress supported excluding passive income from the tax on unrelated business income on the ground that passive income was not likely to result in serious competition for taxable businesses.<sup>115</sup> It has also been supported on the ground that it appropriately encourages exempt organizations to limit their level of participation in income-producing activities to passive investments, which are seen as less of a distraction from the organization's exempt purposes than is active participation in business enterprises.<sup>116</sup> The passive income exception also assists charitable organizations in gaining some degree of independence, and gives them the ability to weather unforeseen events in lean economic times.<sup>117</sup> Finally, an argument can be made that the passive income exclusion is a logical extension of the charitable contribution deduction, which allows corporate taxpayers a deduction for donations to charity.<sup>118</sup>

An analysis of the soundness of these arguments is beyond the scope of this Article. Suffice it to say, that the passive income exclusion for charitable organizations appears — at least for the moment — to be well accepted. Neither Congress nor the Treasury has seriously questioned the exclusion for passive income for

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114. See, e.g., Break & Pechman, *Relationship Between the Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 341, 344 (1975).

115. See *supra* notes 15-19 and accompanying text.

116. *Unrelated Business Income Tax*, *supra* note 109, at 46. See also COMM. ON WAYS AND MEANS, 89TH CONG., 1ST SESS., TREASURY DEPT'S REPORT ON PRIVATE FOUNDATIONS 34-35 (Comm. Print 1965).

117. See Break & Pechman, *supra* note 114, at 344.

118. Although subject to numerous restrictions and qualifications, section 170 generally allows taxpayers a deduction for donations to charity. If charitable organizations were subject to tax on investment income, presumably they also would be allowed a charitable deduction. Since a charitable organization's income is required by law to be irrevocably committed to charitable purposes, the only question would be the timing and the amount of the deduction.

these organizations.<sup>119</sup> Congress has focused on the debt-financed property rules, which it has reviewed and amended numerous times in the 1980s, without any suggestion that the underlying exclusion for passive income is not justified. Moreover, in testimony before Congress in 1987, the Treasury Department affirmatively supported the passive income exclusion for charitable organizations.<sup>120</sup> Finally, the Ways and Means Oversight Subcommittee has not questioned the fundamental policy of the exemption for passive income of charitable organizations.<sup>121</sup>

### C. Accountability

#### 1. Overview

Congress has never expressly embraced the Treasury Department's argument that income from debt-financed property should

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119. The Treasury Department and the Oversight Subcommittee of the House Committee on Ways and Means have periodically questioned the operation of the exclusion. For example, they have questioned whether the royalty exclusion should be available for amounts determined on the basis of taxable income. Also, they have questioned the operation of rules under section 512(b)(13) dealing with passive income received from controlled corporations. See *Unrelated Business Income Tax*, *supra* note 109, at 18, 48 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary, Department of the Treasury); Press Release No. 25, Comm. on Ways and Means, U.S. House of Representatives (June 17, 1987), reprinted in *Unrelated Business Income Tax*, *supra* note 109, at 2-4.

Excise taxes are imposed on the investment income of private foundations. I.R.C. § 4940 (1986). Congress has considered imposing excise taxes on other exempt organizations as well, even though they act as a limitation on the passive income exclusion. The rationale for an excise tax on the investment income of private foundations is unrelated to the policy for exempting passive income. The only purpose of the excise tax was to ensure that private foundations bore the cost inherent in administering the complex rules which restrict the activities of private foundations (added in 1969). See H.R. REP. NO. 413, 91st Cong., 1st Sess., reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1663; S. REP. NO. 552, 91st Cong., 1st Sess., reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2053.

In 1987, the Joint Committee on Taxation recommended an excise tax on the investment income of exempt organizations in its list of revenue options submitted to Congress. The policy reason underlying the proposal was influenced, in part, by the existence of a large federal budget deficit. The Committee further reasoned that tax-exempt organizations ought to share in the cost of government because they benefit from their tax-exempt status and because they enjoy access to a multitude of government services. See JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES PREPARED FOR THE COMM. ON WAYS AND MEANS 275-76 (Comm. Print 1987). In the context of charitable organizations, the passive income exclusion for organizations exempt under sections other than section 501(c)(3), such as social welfare organizations (section 501(c)(4)), labor unions (section 501(c)(5)), and trade associations (section 501(c)(6)) has been questioned by the Treasury and Congressional staff.

120. *Unrelated Business Income Tax*, *supra* note 109, at 18, 46.

121. See Press Release No. 16, *supra* note 109; DAILY EXECUTIVE REP. (BNA) (June 24, 1988).

be taxed so that charities will seek growth through public support instead of leveraged investments.<sup>122</sup> Nevertheless, Congress did enact legislation in 1969 that taxed all income from debt-financed property without regard to whether the transaction presented any potential for abuse. The reasons for this movement toward the Treasury Department position have never been altogether clear. Recognizing that the 1950 business lease provision had failed to terminate the problems represented by sale and lease-back transactions, perhaps Congress passed the broader provision in 1969 because it concluded that a narrow statute could not successfully end abusive transactions. Alternatively, there may have been some agreement in the Congress with the Treasury Department's views that is not reflected in the legislative record. Whatever Congress' intent may have been in 1969, given the confused state of the law today and the fact that the Treasury's arguments are the only views ever articulated as justification for taxing all debt-financed income,<sup>123</sup> a fresh look at these arguments is now appropriate.

The Treasury Department's argument that debt-financed investment income should be taxed to encourage charitable organizations to be dependent upon the public for financial support is premised on the theory that such dependency ensures accountability to the public.<sup>124</sup> That exempt organizations should be accountable to the public seems clear beyond peradventure. If one accepts the proposition that tax exemption (and the eligibility to receive tax deductible charitable donations) is a valuable benefit that is granted to charitable organizations because they serve a public rather than a private purpose, it follows that the government has a duty to ensure that such organizations are in fact serving the public. Yet, assessing accountability is difficult due to definitional problems, and due to the immense size of the charitable sector. Moreover, the formal procedures at the federal level for ensuring accountability are limited. Each of these issues will be discussed in turn.

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122. See *supra* notes 54-55 and accompanying text.

123. The Treasury Department favors the application of a tax on all debt-financed income. Such a tax is needed because any statute which allows a tax-free return on debt-financed income is too prone to abuse. See *supra* note 78 and accompanying text.

124. H.R. REP. NO. 413, 91st Cong., 1st Sess. pt. 1, at 41, *reprinted in* 1969-3 C.B. 200, 227; S. REP. NO. 552, 91st Cong., 1st Sess. 56-57, *reprinted in* 1969-3 C.B. 423, 460-61 (support requirement in I.R.C. § 509 — which defines section 501(c)(3) organizations that are not private foundations, and thus are public charities — is designed to ensure that public charities are responsive to the needs of the public).



## 2. Definition of Charitable Organization

Section 501(c)(3) currently grants tax exemption to a broad and diverse group of organizations. Specifically, section 501(c)(3) exempts from tax "[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . , or for the prevention of cruelty to children or animals . . . ." <sup>125</sup> Treasury regulations provide that "[t]he term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of 'charity' as developed by judicial decisions." <sup>126</sup> The regulations further provide that the term "charitable" includes: "[r]elief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency." <sup>127</sup> The only essential element to obtaining exemption under section 501(c)(3) is that the organization serve a public rather than a private purpose. <sup>128</sup>

## 3. Size of the Charitable Sector

Currently, there are nearly 390,000 religious (excluding churches), educational, charitable, and scientific organizations listed in the IRS Master File as exempt under section 501(c)(3). <sup>129</sup> The operating expenditures of exempt organizations have been estimated to be six percent of the gross national prod-

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125. I.R.C. § 501(c)(3) (1986).

126. Treas. Reg. § 1.501(c)(3)-1(d)(2)(as amended in 1976).

127. *Id.*

128. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii)(as amended in 1976).

129. *Unrelated Business Income Tax*, *supra* note 109, at 26. The IRS Master File is a compilation of those organizations that have applied to the Internal Revenue Service for tax exemption and been granted tax exemption. *Id.* at 26 n.1.

uct,<sup>130</sup> and section 501(c)(3) organizations account for most of this wealth.<sup>131</sup> Total employment in the nonprofit sector (both paid and volunteer) accounts for approximately ten percent of total hours worked in the United States economy.<sup>132</sup>

#### 4. Oversight by the Federal Government

Notwithstanding the breadth of the definition of "charitable organization" and the size of the exempt sector, the only formal oversight responsibility at the federal level is exercised by the Internal Revenue Service in its capacity as the federal agency charged with administering the tax laws.<sup>133</sup> The Service fulfills this function through the exemption application process and subsequent audits of information returns filed by exempt organizations. The Service's resources, however, are limited. In 1986, slightly more than 400,000 exempt organization information returns were filed,<sup>134</sup> and the Service audited approximately five percent of them.<sup>135</sup> Moreover, its primary enforcement tools are the revocation of exempt status for organizations that extend their activities beyond the scope of their exemption and the imposition of the unrelated business income tax. At the federal level, there are no rules designed to ensure that public charities act prudently and in the public interest. No federal agency systematically reviews the activities of exempt organizations. Similarly, no federal agency evaluates whether the public is receiving a benefit that justifies the dollars foregone in tax revenues. At the federal level, this task has been left instead to the public which is expected to discharge this vital function by granting or withholding financial support.

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130. *Id.* at 26 (this figure is based on 1985 estimates by the Bureau of Economic Affairs).

131. UNITED STATES GENERAL ACCOUNTING OFFICE, COMPETITION BETWEEN TAXABLE BUSINESSES AND TAX-EXEMPT ORGANIZATIONS (GAO/GGD-87-40 BR) 15 (1987).

132. *Id.*

133. State governments exercise jurisdiction over charitable organizations in matters that do not involve the federal income tax exemption.

134. *Unrelated Business Income Tax*, *supra* note 109, at 70 (statement of Lawrence B. Gibbs, Commissioner of the Internal Revenue Service). An additional 500,000 exempt organizations avoided the filing requirement because they were churches or because they did not have more than \$25,000 in gross receipts. *Id.*

135. *Id.*

### 5. The Debt-Financed Property Rules as a Means of Ensuring Accountability

Given the broad definition of charitable organizations, the very limited resources the government devotes to monitoring these organizations, and the significant size of the charitable sector, concern about accountability is justified. It is not at all clear, however, that taxing debt-financed income is an effective means of ensuring that charitable organizations are accountable to the public for the benefits of tax-exempt status.

The debt-financed property rules are a very indirect means of encouraging reliance on public support. The rules may slow the accumulation of wealth by charitable organizations, but they do not prohibit the accumulation of wealth. To the extent that the debt-financed property rules do make charitable organizations more reliant on public support, they may help to ensure accountability in a very broad sense. The public, by selecting the organizations it will support through contributions and membership dues, directs the benefit of the federal tax exemption to those activities it considers most valuable. It is questionable, however, whether dependence on public support leads to meaningful public scrutiny. One would suspect that many small donors to large charitable organizations have little knowledge of the organization's specific activities and operations.

Not only are the debt-financed property rules an extremely indirect and ineffective means of ensuring accountability, they are also unnecessary because the private foundation rules<sup>136</sup> perform this task. Enacted in 1969, the same year the debt-financed property rules were enacted, these rules impose stringent requirements designed to ensure the accountability of all charitable organizations that lack public support. All section 501(c)(3) organizations are classified as private foundations unless they satisfy one of three tests. Each of the three tests is intended to require a certain degree of public support and involvement.

First, "public institutions" are excepted from classification as private foundations. Included in this category are churches, schools, hospitals, certain organizations providing support for public colleges and universities, and governmental units (i.e., a state, possession of the United States, or the District of Columbia).<sup>137</sup>

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136. See I.R.C. §§ 509, 4940-4946 (1986).

137. I.R.C. § 509(a)(1) (1986). Churches and schools are inherently dependent on

Second, publicly supported organizations are not private foundations. Publicly supported organizations include any organization that normally receives: (1) more than one-third of its support in each taxable year from any combination of gifts, grants, contributions, or membership fees, and gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in an activity that is not an unrelated trade or business, excluding certain large receipts and receipts from disqualified persons, and (2) no more than one-third of its support in each taxable year from gross investment income and after-tax unrelated business taxable income.<sup>138</sup>

Third, "supporting organizations" are not private foundations. Supporting organizations operate exclusively for the benefit of, perform the functions of, or carry out the purposes of specified public institutions or publicly supported organizations, and are operated, supervised, or controlled by one or more such organizations and are not controlled by disqualified persons.<sup>139</sup>

Charitable organizations classified as private foundations are subject to a series of rules intended to ensure that they are accountable for their exempt status.<sup>140</sup> Specifically, they are subject to rules that prohibit self-dealing with persons and entities closely related to the foundation,<sup>141</sup> rules that require distribution of a minimum amount of income for charitable purposes each year,<sup>142</sup> rules that prohibit large ownership interests in active businesses,<sup>143</sup> rules that restrict investments which jeopardize the organization's charitable purpose,<sup>144</sup> and rules that ensure that the foundation's funds are expended for purposes that will serve a public rather than a private purpose.<sup>145</sup> The private foundation rules appear to have worked quite well to ensure that those organizations classi-

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public support. If the public did not have a need for these services, the institutions would have no purpose. By contrast, because less choice is involved in using hospitals, it is not so clear that public support is inherently a part of the operation of a hospital.

138. I.R.C. § 509(a)(2) (1986).

139. I.R.C. § 509(a)(3) (1986).

140. See generally I.R.C. §§ 4941-4946 (1986).

141. I.R.C. § 4941 (1986).

142. I.R.C. § 4942 (1986).

143. I.R.C. § 4943 (1986).

144. I.R.C. § 4944 (1986). An investment may jeopardize the organization's purpose if the managers have failed to exercise ordinary business care and prudence in providing for the short and long-term financial needs of the foundation to carry on its exempt purpose. Treas. Reg. § 53.4944-1(a)(2) (as amended in 1973).

145. I.R.C. § 4945 (1986).

fied as private foundations are accountable for their exempt status.<sup>146</sup>

If there is a concern that other charitable organizations are not serving the public interest, that concern should be expressly addressed and rules directed to specific problems should be developed. The taxation of income from debt-financed property cannot be expected to achieve accountability to the public and should not be defended on the grounds that it does achieve this goal.

#### D. Section 514 as an Anti-Abuse Measure

##### 1. Overview

The debt-financed property rules were enacted to solve the problems that arose from sale and lease-back transactions.<sup>147</sup> The rules have been cited by the Treasury Department as necessary to prevent charitable organizations from transferring the benefits of their exemption to taxable persons through partnership allocations.<sup>148</sup> The rules, however, were drafted broadly to tax income from all debt-financed investment property.

The breadth of the debt-financed property rules might once have been defended on the grounds that debt-financed investments are not necessary to the achievement of any exempt purpose and that it is difficult to draft a provision that is specifically targeted at potential problems. Balancing the lack of any compelling need for exempt organizations to acquire debt-financed property against the difficulty of preventing potential problems through a narrow provision, Congress might reasonably have concluded that taxation of all debt-financed property was justified. The force of this argument, however, has been dissipated by the enactment of section 514(c)(9), which indicates that Congress believes a narrow provision is adequate to prevent abuse. This section of the Article examines the effect of borrowing by exempt organizations, and the effect of section 514(c)(9) on sale and lease-back transactions and

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146. In 1983 and 1984, the Subcommittee on Oversight of the Committee on Ways and Means conducted hearings to review the private foundation provisions. See *Hearings on Private Foundations Before the Subcomm. on Oversight, Comm. on Ways and Means*, 98th Cong., 1st Sess. (1983). The Subcommittee concluded that no significant changes were needed. HOUSE SUBCOMM. ON OVERSIGHT, 98TH CONG., 1ST SESS., REPORT AND RECOMMENDATIONS CONCERNING FEDERAL TAX RULES GOVERNING PRIVATE FOUNDATIONS 42-43 (Comm. Print 1983).

147. See *supra* notes 20-33 and accompanying text.

148. See *supra* notes 77-79 and accompanying text.

partnership allocations.

## 2. The Effect of Borrowing by Charitable Organizations

Taxation of all income from debt-financed investment property would be desirable if borrowing would give tax-exempt investors an advantage over taxable investors that would enable tax-exempt investors to pay a higher price for an asset or to acquire property without risking any of its own funds. No such advantage results from the mere act of borrowing. For both a tax-exempt and a taxable investor, the advantage of borrowing arises as a result of the difference between the interest paid on the loan and the profit earned on the investment. Thus, if an investor borrows at an interest rate of ten percent to acquire an investment that yields a return of twelve percent, his net profit arises from the two percent difference. If a charitable organization was tax-exempt on such an investment, it would not obtain any advantage that is not inherent in the tax exemption for passive investment income. Thus, unless one is to argue that the passive income exception itself gives rise to potential problems, there is no reason to argue that investment income should be taxed solely because it is acquired with borrowed funds.

An advantage would accrue to the charity if it could obtain a more favorable rate of interest than a taxable investor. It is not known whether charities obtain more favorable interest rates from commercial lenders than do taxable investors. One obvious, but limited, source of more favorable interest rates for charities is the tax-exempt bond market. Although tax-exempt bonds may not be used to acquire investments, this restriction only prohibits "direct" use of tax-exempt bonds for investments. A charity may "indirectly" use tax-exempt bonds to finance investments when it uses the bonds to borrow for an exempt purpose that it could have financed out of proceeds from the sale of investments. Although this potential for advantage exists, the taxation of debt-financed property has no impact on it because the advantage arises from the ability to obtain a lower rate of interest and not from the exempt status of the income.

Because interest is generally a deductible expense, the tax system may actually provide taxable investors with a competitive advantage over tax-exempt investors in some circumstances. If a taxable investor is able to obtain a tax benefit from the deduction of interest that is greater than the tax cost associated with the income from the debt-financed property, then it would have an

advantage over a tax-exempt investor that is not taxed on the leveraged income but also is not allowed a deduction for interest paid on the indebtedness incurred in acquiring the investment. Numerous rules in the tax law are designed to preclude taxable investors from obtaining this advantage.<sup>149</sup>

### 3. Sale and Lease-Back Transactions

The advantage that charities obtained over taxable investors through sale and lease-back transactions arose not from the combination of tax-exempt income and borrowing alone, but was dependent upon the existence of a number of other factors as well. These included "rents" that were stated as a percentage of profits, borrowing that was nonrecourse, financing provided by the seller of the property, and repayment of the borrowing solely out of the profits of the acquired property. Because the charity was not personally liable for the loan and the loan was repaid solely out of profits, the charity was not required to risk its own funds. Because it was not paying for the property out of its own funds, it is reasonable to assume that the charity would pay whatever price the "seller" demanded so long as the price was not higher than the price demanded by other sellers.<sup>150</sup>

The conditions imposed by section 514(c)(9) as prerequisites to avoiding taxation of income from debt-financed property appear to render these benefits of the pre-1969 sale and lease-back transaction unattainable. Specifically, section 514(c)(9) requires: that the price be a fixed amount; that the time and amount of payments on the debt not be dependent upon revenue, income, or profits derived from the property; that the real property cannot be leased to, or its acquisition financed by, the seller or to any person related to the seller; that the real property cannot be leased to, or its acquisition financed by, persons bearing certain relationships to a pension fund that holds the real property; and that a partnership holding real property conform with certain restrictions on allocations among partners.<sup>151</sup> While taxing the income from debt-fi-

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149. See, e.g., I.R.C. § 265(2) (1986)(no deduction allowed for interest expense incurred to generate tax-exempt interest income); I.R.C. § 163(d) (1986)(limiting the deductibility of interest paid on investment indebtedness).

150. Some authors have questioned whether Congress was correct in its assumption that charitable organizations paid a price in excess of fair market value in sale and lease-back transactions. See, e.g., Hall, *supra* note 28, at 343.

151. I.R.C. § 514(c)(9) (1986).

nanced property also removes a critical element from the sale and lease-back transaction and renders its benefits unattainable, it is a broader remedy than necessary to cure the problem of the sale and lease-back transaction.

#### 4. Partnership Allocations

In a partnership, the potential for the benefits of tax exemption to taxable persons arises from the partnership's ability to allocate items of profit, loss, income, and deduction among partners. If the income from the partnership is not taxable to a tax-exempt partner, the losses and deductions will be of no value to it. The tax-exempt partner may be willing to agree to allocate such losses and deductions to taxable partners, perhaps in exchange for a higher percentage of income and profits. The fact that the partnership property is encumbered by debt increases the potential for transferring the benefits of tax exemption because it creates greater tax losses.<sup>152</sup> Debt financing does not, however, create the potential for transferring such benefits in the first instance.

Taxing income from debt-financed property only partially eliminates the potential for transferring the benefits of tax exemption through partnership allocations. To the extent that a tax-exempt partner is taxable, it is on a par with the non-exempt partners. Accordingly, it will be unwilling to give up its share of the deductions and losses. The debt-financed property rules, however, fail to place exempt partners and non-exempt partners in the same position because they subject the exempt partner to only partial taxation. It is taxed only on that portion of its income that is debt-financed while the non-exempt partner is fully taxable on its income. Consequently, unless the property is 100 percent debt-financed, the exempt partner's effective tax rate will still be lower than that of the non-exempt partner. Therefore, any tax benefits will still be less valuable to the exempt partner than to the non-exempt partner.<sup>153</sup> Moreover, the debt-financed property rules impose no restrictions on partnership allocations if the partnership

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152. *See Crane v. Commissioner*, 331 U.S. 1, 11 (1947)(ruling that an investor may include the value of his property, unreduced by any mortgage, when computing his depreciable basis).

153. The debt-financed property rules may have more force as a practical matter than they have in theory. Because many charitable organizations seek to avoid any liability for the unrelated business income tax, they may insist on an allocation that meets the requirements of § 514(c)(9)(B)(vi) to avoid even a small tax.



does not acquire debt-financed property.<sup>154</sup>

If properly drafted, restrictions on partnership allocations (regardless of whether the partnership property is debt-financed) are a more effective means of preventing abuse than the taxation of debt-financed property. The qualified allocation rules that were added to section 514(c)(9) in 1984 were clearly sufficient to prevent abuse in those partnerships that acquired debt-financed property. These rules, however, were criticized as being inconsistent with industry practices.<sup>155</sup> Through the post-1984 amendments, Congress has sought to develop restrictions that take into account the conventional practices in the real estate industry and still prevent the transferring of the benefits of tax exemption to taxable partners.<sup>156</sup> To date, that objective has not been achieved.

## 5. Summary

The acquisition of property by an exempt organization with borrowed funds does not necessarily give rise to any potential problems, and does not give the exempt organization an advantage over taxable persons that the organization does not also enjoy in an unleveraged investment. Borrowing was but a single element in the sale and lease-back transactions and partnership allocations that Congress viewed as objectionable. The taxation of income from debt-financed property is an indirect means of preventing these objectionable transactions. In the case of sale and lease-back transactions, the taxation of debt-financed property is an over-broad response because the potential for abuse exists only with certain types of borrowing. While one can never be certain that any provision is adequate to prevent every conceivable problem, section 514(c)(9) appears sufficient to prevent the problems that arise in sale and lease-back transactions.

In the case of partnership allocations, the taxation of income from debt-financed property is too narrow a response. First, the taxation of debt-financed property does not place the exempt partner on a par with the taxable partner. Second, potential problems arise not from borrowing, but from the ability to allocate items of

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154. Section 704(b) and the extensive regulations thereunder require that partnership allocations have substantial economic effect.

155. See Feder & Scharfstein, *Leveraged Investment in Real Property Through Partnerships by Tax Exempt Organizations After the Revenue Act of 1987 — A Lesson in How the Legislative Process Should Not Work*, 42 TAX LAW. 55 (1988).

156. *Id.*

profit, loss, income, and deduction among the partners. The magnitude of the problem is increased, but the problem is not created, by the existence of borrowing. Congress should continue to focus its efforts on developing restrictions on partnership allocations. In addition, consideration should be given to extending the restrictions developed under section 514(c)(9) to all partnerships that have tax-exempt and taxable partners.

## E. Extension of the Section 514(c)(9) Exception

### 1. To Other Exempt Organizations

If the current provisions of section 514(c)(9) are sufficient to prevent any abuse from arising through the acquisition of debt-financed real property,<sup>157</sup> there is no policy reason for limiting the benefits of those provisions to qualified pension plans and schools. In the context of an anti-abuse measure, there is no difference between pension plans and schools, on the one hand, and other section 501(c)(3) organizations, on the other. Circumstances that would give rise to objectionable transactions in the latter group would have the same effect on transactions in the former group.<sup>158</sup> Accordingly, if Congress views the debt-financed property rules as an anti-abuse measure, it should extend the exception of section 514(c)(9) to all section 501(c)(3) organizations.

### 2. To Other Types of Property

Limiting the exception to the debt-financed property rules to real property has been justified for two reasons. First, it has been argued that debt-financing is the conventional means of acquiring real estate and that, as a practical matter, exempt organizations will be excluded from this market if they are taxed on debt-financed income.<sup>159</sup> Second, it was argued in 1980 that exempt organizations, when taxed under section 514, were taxed at a higher

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157. This assumes that the regulations to be promulgated by the Treasury Department under the authority of the 1988 Act will not allow charitable organizations to transfer the benefits of exemption to taxable persons.

158. There is, however, a distinction between pension plans and schools with respect to the issue of accountability. Pension plans owe a fiduciary duty to plan participants and accountability to those participants is regulated under the Employee Retirement Income Security Act. The notion of dependence on the public for support through donations and membership fees has no relevance to pension plans.

159. See *supra* note 66 and accompanying text.

rate than taxable entities.<sup>160</sup> If taxation of debt-financed income is viewed as an anti-abuse measure, neither of these considerations is significant. The fact that debt is a conventional means of acquiring real estate would not justify excluding real estate from the debt-financed property rules if an exclusion would create the potential for abuse. It was inequitable that exempt organizations were taxed under section 514 at a more onerous rate than taxable organizations. Exempt organizations, when subject to tax, should generally be taxed in the same manner as taxable entities. The exception to the debt-financed property rules eliminates the inequity by expanding the range of exempt income for exempt organizations; but again, this would not be an acceptable means of correcting the inequity if it opened up an avenue for abuse.

The pertinent question in considering whether the exception in section 514(c)(9) should be extended to personal property is whether transactions in personal property give rise to potential problems that do not exist with transactions in real property, and if so, whether these problems can be prevented through provisions such as those contained in section 514(c)(9) that are directly aimed at the elements of the transaction giving rise to the objectionable result. This is not an easy question. Given the much-acclaimed ingenuity of the tax bar and the complexity of the tax laws, as well as the complexity of today's financial products, the section 514(c)(9) exception should not be extended to personal property without careful deliberation. It is not clear that transactions in personal property will not give rise to new opportunities for exempt organizations to transfer the benefits of their tax exemption to taxable persons.

### CONCLUSION

The debt-financed property rules are not an effective means of ensuring that charitable organizations are accountable for their tax exemption. If there is a concern that charitable organizations are not serving a public purpose, the question should be reviewed and specific remedies developed. The only remaining reason for taxing all debt-financed income is the argument that the potential abuses are so numerous and varied that it is impossible to draft a statute that would foreclose all objectionable transactions. At least with respect to real property, Congress seems satisfied that section

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160. See *supra* note 67.

514(c)(9) is adequate. Its provisions should be extended to all section 501(c)(3) organizations because these organizations do not present any greater potential for objectionable transactions than do pension trusts and schools. Whether section 514(c)(9) is adequate to prevent objectionable transactions arising from debt-financed acquisitions of personal property requires further study.

